Office of Chief Counsel Internal Revenue Service

memorandum

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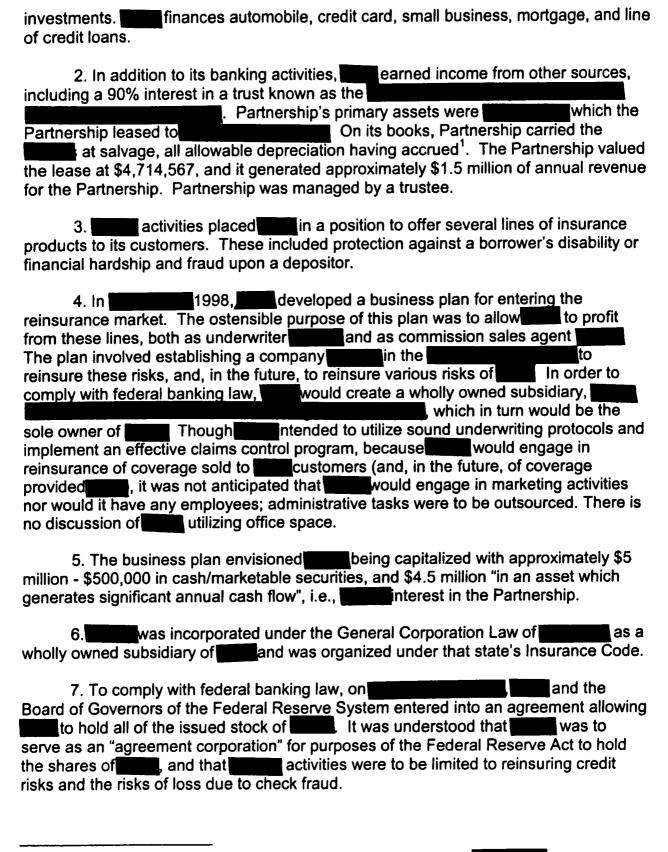
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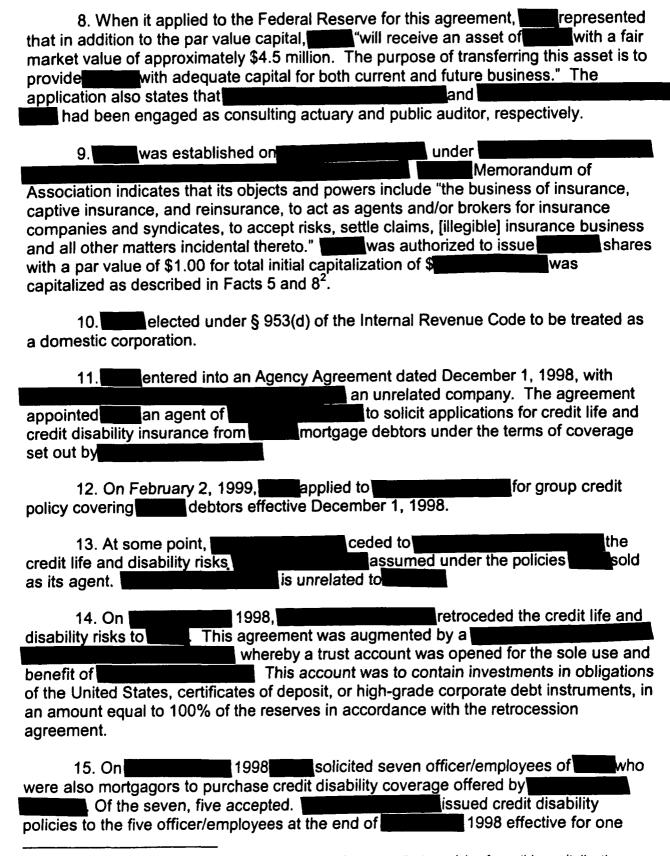
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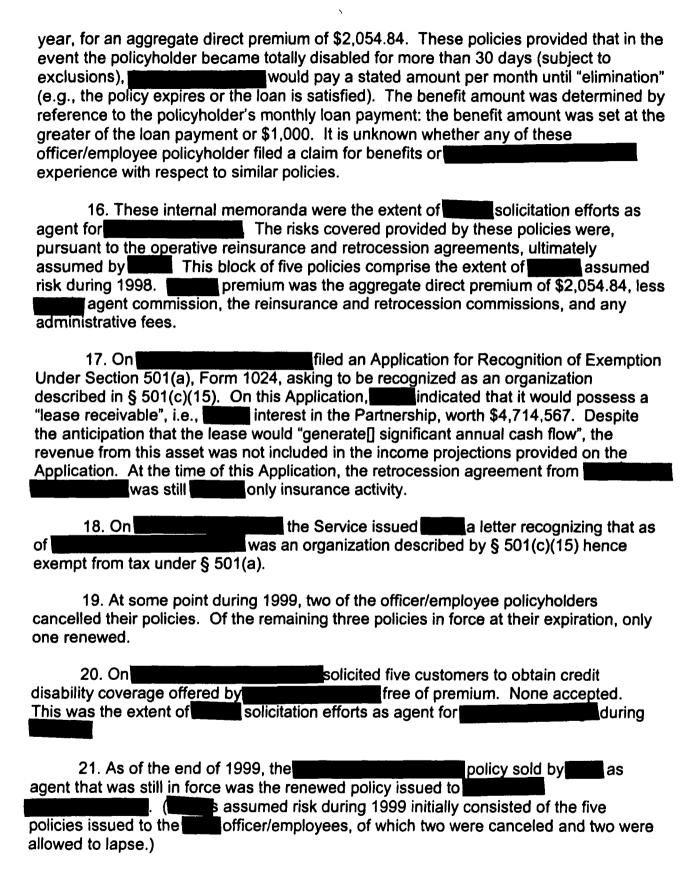
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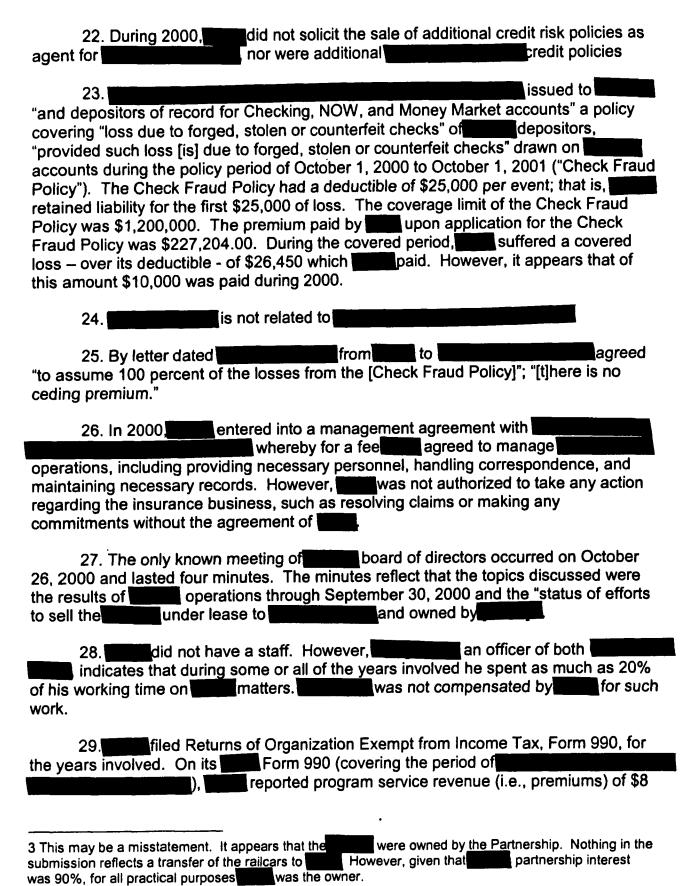


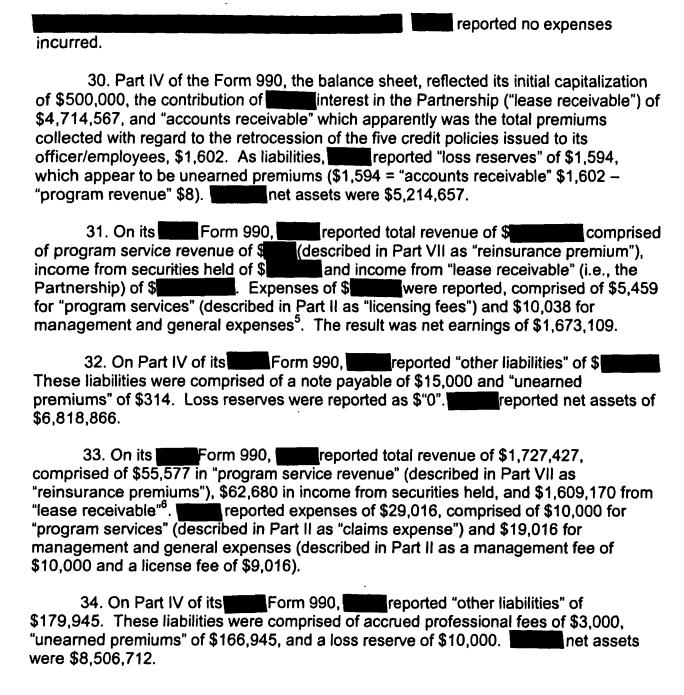
¹ The partnership agreement provided that the depreciation was allocable to



² We offer no opinion on the tax consequences of, or the tax attributes arising from, this capitalization.







⁴ The Form 990 is confusing on this. Part IV-A, book-tax reconciliation, reflects that the Partnership produced \$1,487,296 of revenue instead of the \$1,634,347 reported under Part I.

⁵ Given that indicated that he was not compensated by the for his work on its behalf, and that the agreement with was not reached until the was not sure what this expense was for.

⁶ There is a discrepancy in 2000 Form 990 similar to that described at note 8.

LAW and ANALYSIS

a. Law

The business of an insurance company necessarily includes substantial investment activities. Both life and nonlife insurance companies routinely invest their capital and the amounts they receive as premiums. The investment earnings are then used to pay claims, support writing more business or to fund distributions to the company's owners. The presence of investment earnings does not, in itself, suggest that an entity does not qualify as an insurance company.

For the years involved, an insurance company for federal income tax purposes is a company whose primary and predominant business activity during the year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Section 1.801-3(a)(1) of the Income Tax Regulations; § 816(a) (company treated as an insurance company for purposes of definition of a life insurance company only if "more than half of the business" of that company is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies).

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The United States Supreme Court, however, has explained that for an arrangement to constitute insurance for Federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. LeGierse, 312 U.S. 531 (1941). The risk shifted and distributed must be an insurance risk. See, e.g., Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190 (7th Cir. 1978), cert. denied, 439 U.S. 835 (1978); Rev. Rul. 89-96, 1989-2 C.B. 114.

Risk shifting occurs if a person facing the possibility of an economic loss resulting from the occurrence of an insurance risk transfers some or all of the financial consequences of the potential loss to the insurer. The effect of such a transfer is that a loss by the insured will not affect the insured because the loss is offset by the insurance payment. Risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987). Risk distribution necessarily entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. See Humana, Inc. v. Commissioner, 881 F.2d 247, 257 (6th Cir. 1989).

While a taxpayer's name, charter powers, and state regulation help to indicate the activities in which it may properly engage, whether the taxpayer qualifies as an insurance company for tax purposes depends on its actual activities during the year. Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497, 506-08 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972) (taxpayer whose predominant source of income was from investments did not qualify as an insurance company); see also Bowers v.

Lawyers Mortgage Co., 285 U.S. 182, 188 (1932). To qualify as an insurance company, a taxpayer "must use its capital and efforts primarily in earning income from the issuance of contracts of insurance." Indus. Life Ins. Co. v. United States, 344 F. Supp. 870, 877 (D. S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973). All of the relevant facts will be considered, including but not limited to, the size and activities of any staff, whether the company engages in other trades or businesses, and its sources of income. See generally United States v. Home Title Ins. Co., 285 U.S. 191, 195 (1932) (where insurance and charges incident thereto were more than 75% of company's income, "[u]ndeniably insurance [was] its principal business."); Lawyers Mortgage Co. at 188-90; Indus. Life Ins. Co., at 875-77; Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387, 391-92 (N.D. Tex. 1969), rev'd on other grounds, 425 F. 2d 1328 (5th Cir. 1970); Serv. Life Ins. Co. v. United States, 189 F. Supp. 282, 285-86 (D. Neb. 1960), aff'd on other grounds, 293 F.2d 72 (8th Cir. 1961); Inter-American Life Ins. Co., at 506-08; Nat'l. Capital Ins. Co. of the Dist. of Columbia v. Commissioner, 28 B.T.A. 1079, 1085-86 (1933). However, a company engaged solely in reinsurance may have a very sparse operation. See Alinco Life Ins. Co. v. United States, 178 Ct. Cl. 813, 837-38 (1967)(that reinsurance company had extremely simple operation with very little general operating expense did not preclude conclusion that it was a life insurance company under § 801).

In Lawyers Mortgage Co., the Court concluded the taxpayer was not an insurance company based on the character of the business actually done. The taxpayer was chartered as "Lawyers Mortgage Insurance Co." to examine titles and to guarantee or insure bonds and mortgages. Later, the company dropped "insurance" from its name and amended its charter to allow the purchase and sale of mortgage loans. It remained under the supervision of the state insurance department. However, Lawyers Mortgage never insured titles. Rather, it made mortgage loans which it sold with a guarantee of payment. For this "insurance", Lawyers Mortgage charged a "premium" of one-half of one percent of the interest stated on the mortgage. The company also guaranteed the payment of some loans which it did not make or sell. Under state law, companies chartered as banks were also authorized to conduct this type of business. The Court concluded that though the guarantees were in legal effect insurance, this element of Lawyers Mortgage's activities was only incidental to the mortgage business; the "premium" covered non-insurance services. And the "premiums" were only one-third of Lawyers Mortgage's income. The character of the business actually done was not insurance, therefore, the company was not an insurance company.

Similarly, in <u>Industrial Life Ins. Co.</u> the taxpayer was not an insurance company for federal income tax purposes because it was not using its capital and efforts primarily to earn income from insurance. Industrial Life was chartered as an insurance company but did not maintain a sales staff. Its office was located in the home of its president. During the three years at issue, the company's insurance activity consisted of covering small credit risks under a group policy issued to a consumer lender, covering the lives of certain of its officers (the company paid the premiums and was the beneficiary), and

covering the lives of members of the stockholding family. The company also engaged in leasing and selling real estate and managing its investment portfolio. Industrial Life's premium income from insurance issued to parties unrelated to its owners/officers (i.e., the group credit risk policy) accounted for approximately 8% its income during the years at issue. The company accumulated substantial earnings without showing a reasonable need. The district court concluded that Industrial Life was not an insurance company during the years at issue. Although it was involved in direct underwriting, it issued only one policy and its premium income was small compared with its income from its real estate activity.

Cardinal Life Insurance Co. involved a company chartered to write life, health and accident coverage. During two of the five years at issue, Cardinal Life did not issue insurance contracts or reinsure risks underwritten by insurance companies; its premium income was \$0 and it had no reserves. For the remaining three years, Cardinal Life reinsured risks underwritten by an insurance company; its premium income was less than 1% of its income for two of those years and approximately 9% in the third. Its reserves were minimal. Cardinal Life never employed any agents or brokers though it did retain an actuary; the reinsurance agreement was negotiated by its one stockholder. Meanwhile, Cardinal Life had income from dividends and interest, leasing real estate and trailers, and capital gains. The district court concluded that Cardinal Life was not an insurance company because its capital and efforts were devoted primarily to its investment activity; it did not solicit insurance business and derived insignificant amounts of income from what insurance business it transacted while deriving substantial income from its investments.

Inter-American Life Ins. Co. likewise involved a taxpayer that did not qualify as an insurance company due to its minimal volume of insurance business. Two individuals formed Investment Life Insurance Company to directly underwrite coverage which could be ceded to Inter-American. Although Inter-American was authorized to use several policy forms, it did not solicit or sell any directly written coverage during the years at issue. Rather, it accepted a small amount of business ceded to it by Investment Life and an unrelated insurer. Inter-American also held the family's lumber business as loaned surplus. Because of its minimal insurance activity, the state insurance commissioner became concerned about its continued participation in the insurance market. As a result, rather than surrender its certificate of authority to write insurance, Inter-American retroceded a major portion of its coverage to an unrelated company. Meanwhile, Inter-American realized income from various capital assets. Although Inter-American had as many as 448 policies in force during the five years at issue with an aggregate coverage of \$1.4 million, premiums accounted for 5% or less of Inter-American's income during four of the five years. The court concluded that Inter-American was not an insurance company for any of the years at issue because it did not use its efforts in the insurance business. It did not actively solicit to issue coverage. Its directly underwritten coverage was issued to the owner's family or their tax advisor and its reinsurance was from the related company, Investment Life. Its investment income far exceeded its de minimis earned premiums.

In contrast, the taxpayer in <u>Service Life Ins. Co.</u> was held to be an insurance company under different facts. During the years at issue, Service Life issued life, health and accident policies, and also solicited and arranged mortgage loans with money borrowed from the Federal Home Loan Bank. Between 35,000 and 70,000 policies were in force during the years at issue, representing life coverage of over \$22,000,000. At the same time, only about 1,800 mortgages were outstanding. Service Life's premium income accounted for between 57% and 79% of its total income. Under these facts, the character of the business actually done by Service Life during the years at issue was insurance; hence it was an insurance company.

b. Analysis

No single factor determines whether a company's primary and predominant business activity for a taxable year was the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, in some cases, a start-up company (or a company winding down operations) may qualify as an insurance company even if premiums represent less than half the receipts of the company, provided the company's capital and efforts are devoted primarily to its insurance business.

In a commercial insurer, issued credit liability policies to employees of a Although we received no representations to this effect, we assume issued a sufficient number of other, unrelated contracts in that those issued to employees qualified as insurance contracts in their own right. Risks under those contracts were reinsured with and retroceded to

Both risk shifting and risk distribution are prerequisite to concluding an arrangement qualifies as an insurance contract for federal income tax purposes. In particular, risk distribution incorporates the "law of large numbers" to allow the insurer to reduce the possibility that a single costly claim will exceed the amount available to the insurer for the payment of such a claim. As noted above, risk distribution also entails a pooling of premiums, so that a potential insured is not in significant part paying for its own risks. Even if the contracts issued by qualified as insurance contracts by virtue of that company's other business, it is necessary to consider whether the risks ceded to and retroceded to represented a sufficient number of insureds to qualify as a block of insurance business as to the fact that a fronting company itself qualifies as an insurance company does not eliminate the need for risk distribution as to the entity that ultimately assumes the underlying risks. Gulf Oil Corp. v. Commissioner, 914 F.2d 396, 410-11 (3rd Cir. 1990);

⁷ Although not represented by the parties to the request for technical advice, A.M. Best indicates that had more than \$38 million direct written premiums, and rated the company A+.

Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 56 (1997)(finding risk distribution where subsidiary reinsures risks of sister corporations), appeal dismissed, 194 F.3d 1330 (Fed. Cir. 1999). In the present case, the block of business assumed from represented the credit disability risks of individuals. These are too few "insureds" for the risks assumed by to constitute reinsuring of risks underwritten by an insurance company. Even if the retrocession of the contracts issued to the employees constituted reinsuring risks underwritten by an insurance company, was an insurance company for federal income tax purposes during only if this was its primary and predominant business activity.
tax year lasted 21 days. During this time, it was established, capitalized, licensed, and entered into the retrocession agreement with representing five "insured" employees of the last last last last last last last last
Under the facts presented, we cannot conclude that was an insurance company for federal income tax purposes during 1998.
2.
During two of the five credit disability policyholders cancelled their policies. Of the remaining three policies in force at their expiration, only one renewed. On solicited five customers to obtain credit disability coverage through to secure additional policyholders. No other efforts were made by to secure additional policyholders. Thus, at the end of the only a single policyholder remained by reason of the retrocession by Clearly, this did not satisfy the requirement of risk distribution; thus, the retrocession of this policy did not constitute the business of insurance as to
Even if retrocession of the one policy from constituted the business of insurance, this activity was dwarfed by investment activity. Preported premium revenue of \$920, unearned premiums of \$314, and no loss reserves. Its income from securities was \$1,634,247. Premium income was 0.05% of its total income. Inasmuch as its reported loss reserves were \$1 its capital was disproportionately large compared to its assumed risk. Moreover, despite the dearth of insurance activity, during

made no other effort to issue insurance contracts or reinsure risks underwritten by an insurance company.
For did not qualify as an insurance company for federal income tax purposes.
3.
For the year with the coverage was primarily of risks of the arrangement would be akin to that in the coverage was primarily of risks of the coverage was primarily of risks of the depositors, the fact that the coverage was primarily of risks of the depositors, the fact that the coverage was primarily of risks of the depositors, the fact that the coverage extended sufficiently to risks of the depositors, the fact that was also insured may not necessarily prevent insurance characterization. See, e.g., Ocean Drilling & Exploration Co. v. United States, 988 F.2d 1135 (Fed Cir. 1993).
Even if coverage of the Check Fraud Policy qualified as an insurance activity, the efforts in connection with that activity were dwarfed by its investment activities, in particular the Partnership interest. For putative insurance premiums of \$55,577 accounted for less than 4% of its total revenue of \$1,727,427, and its loss reserves of \$10,000° represented less than 1% of its total assets of. Over 95% of its revenue was derived from securities and the Partnership interest. It contracted management tasks to but significantly those tasks did not include insurance-related tasks such as resolving claims or making commitments with respect to the "insurance" operations. The only reported board of directors meeting during lasted four minutes; the minutes of the meeting reflect that the only discussion of prospective activities concerned the Partnership interest.
There is no evidence that made any effort to market insurance or reinsurance other than the retrocession from and the reinsurance from the second sec

earning income from issuing insurance contracts or reinsuring risks underwritten by insurance companies. did not qualify as an insurance company for federal income tax For purposes 10. If you have any additional questions, please contact John Glover at extension 2-

¹⁰ Note that on its Form 990, reported that it was affiliated with The nature and extent of the affiliation is not reported; potentially, these two companies were affiliated as described by § 501(c)(15)(C) had qualified as an insurance company for 13